



AMERICAN ACADEMY *of* ACTUARIES

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**Report from the American Academy of Actuaries'  
Life Capital Adequacy Subcommittee**

**Presented to the National Association of Insurance Commissioners'  
Life Risk Based Capital Work Group**

**Orlando, FL – March 2006**

The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

Life Capital Adequacy Subcommittee

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## **Reinsurance and the Recognition of Dividend Liability in Total Adjusted Capital**

### **Background**

Some time ago the National Association of Insurance Commissioners (NAIC) Life Risk Based Capital (RBC) Working Group asked the American Academy of Actuaries Life Capital Adequacy Subcommittee (LCAS) to examine the situation surrounding the credit to total adjusted capital (TAC) for one half (½) of the dividend liability taken by the ceding company in conjunction with modified coinsurance (modco) reinsurance. At that time, credit to the ceding company was allowed for modco but not for conventional reinsurance. This inconsistency was the source of the interest.

Initially, the LCAS determined that for modco, like conventional reinsurance, credit should not be allowed to the ceding company. After considering comments on that original position, the LCAS reevaluated its position in 2005. This report is the result of that reevaluation, and should only be seen in that context.

In the situation presented by interested parties, both reinsurance and a closed block were present. After much discussion and consideration, the LCAS decided to handle reinsurance and the presence of a closed block as two separate issues. This report covers the reinsurance part. The LCAS plans to look at the closed block issues later.

A considerable amount of time has elapsed since the project began. However, this time allowed appropriate consideration of the issues and time to reach a consensus conclusion. The result is a better conclusion that fits well into the current RBC framework. Like many other RBC calculations, this proposal provides an acceptable approximation of the result one would be able to achieve using an individual company principles-based approach. However, this proposal should be viewed only as an interim solution. A principles-based individual company approach would more properly capture the company's dividend practices in recognizing adverse events and the underlying risks, benefits and guarantees in its reinsurance contract(s).

### **Current Recommendation**

The calculation of TAC allows a credit of ½ of the dividend liability established by the company. We recommend that when reinsurance is involved (coinsurance, modco, or coinsurance with funds withheld), the amount of the dividend liability credit included in TAC by the ceding company be reduced to the extent the ceding company cannot realize the financial benefits associated with a reduction in the dividend liability. At the same time, we recommend that the reinsurer should not be allowed TAC credit for any of the dividend liability, even if the direct writer cannot take the TAC credit unless the reinsurer can demonstrate control over the dividend decision of the direct writer.

In this context, the term “realize the credit” means that the company has an opportunity to benefit from dividend actions and the ability to control them. *In general, this will mean that the TAC credit will not be allowed to either company when a block is reinsured.*

However, in situations involving experience rated refunds (ERR) or other special features, the actuary would normally apply professional judgment to determine the appropriate amount of the TAC credit.

### **Why is TAC credit given?**

After considering the issue for some time, it became evident that the purpose for the dividend liability credit in general was a key consideration in determining the appropriate approach. Three positions were considered:

- Credit is allowed because the accrual method of accounting improperly considers a portion of the dividend liability as a liability when in fact it is surplus.
- Credit is allowed because the company can change the dividend scale this year between the time it is declared by the board and when it is actually paid, thereby increasing its surplus in the year dividends are paid.
- Credit is allowed to reflect the fact that the company can change dividend scales in future years to offset losses created by adverse events.

The LCAS concluded that a company's capacity to change dividend scales in future years to reflect adverse events represented the most appropriate perspective from which to consider the recognition of the credit. Note the LCAS took no position on the reason for the original adoption of the credit. LCAS only assumed that for purposes of determining appropriate credit for the dividend liability going forward, we would assume that the reason for the credit is the ability to affect surplus by reflecting future adverse events through a decrease in the dividend scale.

The reason that the purpose of the dividend liability credit is important is that it helps determine the requirements for taking the credit. Under the view adopted, the ability to realize the credit in the long term is required if the company is to be allowed to take credit. If the first view had been adopted the ability to realize the credit would have been unimportant. If the second had been adopted the ability to realize the credit in the very short term would have been important. With the accepted view, the only issue is the ability of the company to realize the credit in the longer term.

### **What does it mean to realize the credit?**

If a company is to take credit for a portion of the dividend liability, the company must be able to realize that credit. In other words, the company needs to be able to offset losses over time by changing its dividend scale. In reinsurance situations, the extent of a company's ability to make this happen depends on the answers to two questions:

1. **Does the company have total control over the dividend decision?** In some situations, the company that has responsibility for paying the dividend may not control the dividend decision. An example of this concerns coinsurance from the reinsurer's viewpoint. The reinsurer will pay its share of the dividend under the terms of most reinsurance agreements. However, the reinsurer typically does not

control the dividend decision. That is left to the Board of Directors of the direct writer.

2. **Will the benefit of a change in scale flow to the company?** In some situations the benefit of a change in dividend scale may not flow to the company making the decision. Again, consider coinsurance. In this case the direct writer controls the decision to change scale but the benefit of a dividend scale reduction (at least a portion of it) typically would go to the reinsurer.

### **Effect on the credit**

In the event the company does not have the ability to realize the credit associated with the dividend liability, allowing full credit for  $\frac{1}{2}$  the dividend liability in the TAC calculation is not appropriate.

If the company does not have any control of the dividend situation, no credit should be allowed. Control of the dividend decision typically rests with the ceding company. The reinsurer may not take credit for any of the dividend liability in calculating TAC unless it can demonstrate control over the dividend decision.

The benefit flow associated with a dividend change will depend on the provisions of the reinsurance contract. In a typical contract, the reinsurer will share in the dividend payment. As a result, the benefit of any future scale cut will benefit the reinsurer to the extent of the reinsurance. However, some reinsurance contracts may have experience rated refund or other provisions that share the benefit of future experience and dividend scale changes between the companies. In this case, it is possible that a future scale cut could benefit the ceding company with respect to the portion of the business that is reinsured. Further, some reinsurance contracts may not require the reinsurer to share in the dividend payment. Again, in this case the benefit of a future scale change could benefit the ceding company. The actuary would use professional judgment in determining the extent of any future scale change that flows to the ceding company.

In determining the credit in reinsurance situations the actuary would normally consider:

- The degree to which the block is reinsured. For example, under a typical reinsurance arrangement for a block that is 50% reinsured, 50% of the benefit of a future scale cut would go to the reinsurer. In this case the TAC credit to the ceding company would be reduced by  $\frac{1}{2}$ .
- The provisions of the reinsurance agreement regarding sharing dividend payments. For example, under a reinsurance agreement that states that the reinsurer will not share in dividend payments, the full  $\frac{1}{2}$  of the dividend liability TAC credit would be allowed to the ceding company because none of the surplus impact associated with a future scale change would flow to the reinsurer.
- Any provisions for sharing costs in the agreement. For example, under an experience rated refund provision, the actuary will need to determine the extent of the effect of any future scale changes. This will involve a detailed review of the provisions of the ERR formula. The actuary typically would consider what will

happen in adverse situations as this is what the RBC factors are designed to cover. The actuary would also consider the timing of the cash flows associated with the ERR formula.

- Any other relevant provisions of the agreement.

## **RBC Instructions**

The LCAS recommends that the RBC instructions associated with this approach should ask the following two questions concerning business that is reinsured:

- Does your company have "total control" over the dividend decision?
- Does the full benefit of any future ability to change the dividend scale flow to your company?

A “no” answer to the first of these questions would eliminate the company's ability to take full credit for the dividend provision related to the policies reinsured. A “no” answer to the second would indicate that the credit might be limited and that it would be appropriate to use actuarial judgment to determine the amount of the credit.

The LCAS also recommends that references to the actuarial certification and documentation be included, as outlined below. Note that certification and documentation are required whenever a company takes TAC credit for a portion of the dividend liability in coinsurance, modco, or coinsurance with funds withheld situations.

## **Certification**

The LCAS recommends that an actuarial certification covering the judgment used in determining the dividend credit allowed when business is reinsured be included with the company's submission. The certification would be provided by a qualified actuary and would consist of at least the following:

- i. A paragraph identifying the actuary and his or her qualifications.
- ii. A scope paragraph identifying the dividend credit included and certifying to:
  - The Company's control over the dividend decision; and
  - The Company's ability to benefit from the ability to change the dividend scale in the future.
- iii. A reliance paragraph describing those areas, if any, where the certifying actuary has relied on other experts. A reliance statement from each of those relied upon would accompany the certification. The reliance statement would note the information being provided and a statement as to the accuracy, completeness or reasonableness, as applicable, of the information.
- iv. A paragraph certifying that dividend credit taken in calculating TAC was determined in accordance with the principles and requirements of the NAIC RBC instructions.
- v. A paragraph disclosing all material changes in assumptions and methods from those used previously.
- vi. A paragraph stating that the qualified actuary is not opining on the adequacy of the company's surplus or its future financial condition.

## **Documentation**

When taking credit in reinsurance situations, the actuary has the responsibility to document the basis for judgment. The LCAS recommends that an actuarial memorandum be prepared annually and available to regulators on request. As part of the support for the decision to take dividend liability credits, the actuarial memorandum would discuss the material considerations necessary to understand that decision. At a minimum, the memorandum would include the following information:

A list of each treaty for which credit is being taken. For each treaty, the memorandum would describe:

- The block of business covered
- The type of reinsurance (e.g., Modco with ERR) employed
- Contractual/Regulatory/Other restrictions in the treaty which would limit the company's ability to realize the TAC credit associated with the dividend liability to fund needs in other lines of business.
- The rationale for amount of credit taken and the analyses performed